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January 11, 2001

The Honorable Vernon A. Williams
Secretary
Surface Transportation Board
1925 K Street, NW, Suite 715
Washington, DC 20423-0001

Re: Ex Parte No. 582 (Sub-No. 1)
Major Rail Consolidation Procedures -- Notice of Proposed Rulemaking --
Rebuttal Comments of The Kansas City Southern Railway Company

Dear Secretary Williams:

Enclosed for filing are the original and twenty-five copies of the Rebuttal Comments of The Kansas City Southern Railway Company on the Notice of Proposed Rulemaking issued by the Surface Transportation Board in *Major Rail Consolidation Procedures*, Ex Parte No. 582 (Sub-No. 1). Also enclosed is a 3.5 inch diskette formatted for Word Perfect containing a copy of this filing.

Please time and date stamp the extra copy of the Comments and return it with our messenger.

Please feel free to contact me if you have any questions.

Very truly yours,

William A. Mullins

Enclosures

BEFORE THE
SURFACE TRANSPORTATION BOARD

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Ex Parte No. 582 (Sub-No. 1)

MAJOR RAIL CONSOLIDATION PROCEDURES

NOTICE OF PROPOSED RULEMAKING

REBUTTAL COMMENTS OF THE KANSAS CITY SOUTHERN RAILWAY COMPANY

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January 11, 2001

BEFORE THE
SURFACE TRANSPORTATION BOARD

Ex Parte No. 582 (Sub-No. 1)

MAJOR RAIL CONSOLIDATION PROCEDURES

NOTICE OF PROPOSED RULEMAKING

REBUTTAL COMMENTS OF THE KANSAS CITY SOUTHERN RAILWAY COMPANY

Introduction

The Kansas City Southern Railway Company ("KCS") hereby provides the Surface Transportation Board ("STB" or the "Board") with its Rebuttal Comments on the Notice of Proposed Rulemaking ("*NPR*"), served October 3, 2000, in *Major Rail Consolidation Procedures*, Ex Parte No. 582 (Sub-No. 1). KCS has previously stated its general support for the Board's proposed changes to the merger rules.[1] However, KCS also believes that certain adjustments to those proposed changes are necessary to maximize the realizable public benefits from future rail mergers. In KCS' previous filings in this docket, it demonstrated how all of its proposed adjustments to the Board's proposals are relatively minor and are consistent with the Board's evolving notion of the public interest.

[1] KCS previously filed "Comments On The Notice of Proposed Rulemaking" on November 17, 2000, and "Reply Comment on the Notice of Proposed Rulemaking" on December 18, 2000

The seven modest adjustments KCS proposes are:

1. The preservation of rail service options in all rail mergers.
2. Service restrictions contained in marketing, haulage and trackage rights agreements imposed as merger conditions should be disclosed and justified.
3. Benefits claimed from prior mergers should be preserved.
4. Applicants should be required to disclose and discuss the impact of related negotiated agreements in merger proceedings.
5. Recent cancellations of reciprocal switching access should be disclosed and discussed.
6. The definition of "major" merger transactions should be limited to mergers involving only the largest railroads.
7. Merger applicants should be required to disclose and discuss paper and steel barriers applicable to their shortline interchange connections.

These seven administrative adjustments to the Board's merger standards represent a balanced, reasonable approach to bringing the existing merger rules into harmony with the many transformations that have shaped the rail industry in the last twenty years. KCS's proposed adjustments to the Board's proposed rule changes are needed not just to address the fundamental policy shifts that already have occurred under the existing rules but, more importantly, to assure that future merger decisions will continue to be guided by an up-to-date notion of the public interest.

KCS has already outlined the support that its proposals have garnered among the commenting parties, and will not do so here. A few commenting parties do not support KCS' proposals for change. KCS believes that they do not fully appreciate the adjustments proposed by KCS. In the end, any objective review of KCS' proposals establishes that these seven fundamental ideas are balanced, can easily be implemented within the context of the Board's proposed changes, and that the few criticisms that were raised against them are misguided and result from a fundamental misunderstanding of their purpose and effect. In these Rebuttal Comments, KCS will address the critiques leveled at each of its seven proposals.

I. Rail Service Options Should Be Preserved In Merger Proceedings

KCS firmly believes that, over the past few decades, rail mergers have resulted in a diminution in rail-to-rail competition in many markets. The Board and its predecessor agency have routinely approved mergers where the number of rail carriers has been reduced from four to three, or from three to two. Only where rail-to-rail competition is, by definition, being eliminated (that is, where the number of railroads in a market would be reduced from two to one as a result of a merger) have conditions routinely been imposed to maintain some semblance of choice for rail shippers.

The comments filed in this docket reflect little disagreement with the observation that prior mergers have resulted in a reduction in independent rail routing options. That proposition is obvious. Controversy emerges, however, when that factual proposition is examined to determine whether such a reduction in the number of railroads operating in that market actually reduced competition for shippers in that market and, more fundamentally to this proceeding, what the Board should do about future mergers that would reduce competitive rail options even further.

The record in this proceeding presents a number of answers to these questions. At one extreme, many of KCS' Class I brethren would argue that the Board's existing policy has functioned quite effectively to remove unnecessary competitors while retaining some element of choice. Therefore, to these carriers, the status quo will suffice. At the other end of the continuum, certain shippers and shortline railroads express their belief that the unrelenting contraction in independent carriers already has resulted in an unacceptable concentration of duopolistic power in the hands of a few carriers. Some of these parties would use this proceeding to generate rules that would radically alter the competitive landscape with each new merger application through open access or other remedies not related to the actual competitive harms of a proposed merger.

A variety of intermediate positions are argued by other commenting parties. From all of these varied and conflicting views, a practical middle ground must be identified. Only one position will effectively balance the interests at both ends of the aforesaid continuum: as a minimum threshold basis for merger approval, absent compelling circumstances to the contrary, all future major mergers should be conditioned so as to preserve the existing, pre-merger rail-to-rail options in any horizontal market or between any parallel origin and destination corridor.[2] This principle represents the most reasonable middle ground, and the one that would most effectively benefit all parties to this debate. If a consolidation would reduce the number of rail carriers in such markets, some remediation (whether through market-based trackage rights arrangements, divestiture of duplicative facilities, the removal of paper and steel barriers, etc.) would be required. As always, carriers unwilling to except such curative conditions would not be required to consummate their merger.[3]

As a general matter, the nation's largest railroads spent a good deal of their submissions in this docket attacking the Board's proposal to "enhance" competition. Few comments were

[2] In speaking of preserving the existing rail-to-rail competitive options, KCS' focus is on the preservation of competition in horizontal markets. KCS' proposal is not intended to mean that all forms of existing competition need to be preserved; i.e., vertical competition or product or geographic competition. KCS does not intend for its proposed rules to create a per se requirement that all forms of competition need always be preserved. Such forms of competition, those without horizontal aspects, should be subject to a rule of reason analysis.

[3] In seeking the preservation of competitive options, KCS is not discounting the importance of enhancing competition when needed to address adverse competitive impacts of mergers, as proposed by the Board in the *NPR*. However, such enhancements should only be utilized to address reductions in competition brought about by the instant merger, and should not be used as a means of restructuring of the entire rail industry.

made by those carriers on KCS' proposal to set a minimum standard of "preserving" competition. Some carriers, however, have taken issue with proposals advanced by KCS while others have taken the position that future mergers should not result in any further reduction of competition.

To the extent that any of these carriers' comments are directed at KCS' request that rail-to-rail competitive options be preserved,[4] they demonstrate a fundamental misunderstanding of KCS' position. In proposing that conditions be imposed in any future merger proceeding to ensure there is no reduction of horizontal rail-to-rail competition, KCS is not requesting that the Board condition a merger to guarantee traffic to any particular carrier or that the Board somehow subsidize or otherwise "prop up" a rail carrier in a market where its presence is not justified by economic conditions. Instead, all KCS seeks is that another rail carrier ***be given the opportunity to compete*** in a market that would otherwise lose an independent railroad as a result of a merger. If the replacement carrier cannot succeed on a level playing field utilizing the imposed condition, then it can easily exit the field by abandonment or discontinuance, or the rights could be assigned to another willing carrier.

Those who oppose this simple idea presume that competition will not be harmed through elimination of a rail competitor that had sufficient economic reasons to remain in a market pre-merger, but was removed via merger. KCS, on the other hand, believes that, at least with respect to all future mergers, markets will be best served through ensuring that no direct rail-to-rail competition is lost and that the public interest is best served by inserting in the market another independent carrier with the opportunity to "fill the shoes" of the rail competitor lost to the merger. KCS' proposal does not require the establishment of traffic guarantees or any other such

[4] KCS arguments were, in some fashion or another, echoed by the National Industrial Transportation League, The Fertilizer Institute, the American Chemical Council, the Committee to Improve American Coal Transportation ("IMPACT"), and Edison Electric Institute.

forms of protecting competitors nor does it require merger applicants to manufacture "enhanced competition" in markets not adversely affected by the merger. Instead, KCS' proposal preserves competition and allows the market forces to determine thereafter whether the replacement carrier succeeds, without the need for traffic guarantees or continued government regulation..

Some may argue that by insisting upon the preservation of all existing rail-to-rail competitive options in future mergers, the Board's rules might require disapproval of an otherwise highly beneficial merger simply because, in certain, isolated instances, competition is lost and cannot be restored. This argument contains several fallacies. First, the idea that any case of harm to intramodal competition can be unremediable is elusive. Certainly, some form of appropriate remedy, such as divestiture of select lines, trackage rights, or lifting of existing paper barrier restrictions will almost always be available to address any reduction in horizontal intramodal competition. Second, the balancing of harms and benefits may be justified on a macro level, but of necessity, such a balancing test ignores that many shippers will be harmed by a merger without the receipt of any corresponding benefit. The mere balancing of benefits and harms, without a closer scrutiny of who bears the harms and who realizes the benefits, does not adequately address the commentors expressing concern that no further reduction in horizontal rail-to-rail competition should be allowed.[5] Finally, KCS recognizes that in extreme circumstances, it may be possible that some reduction in competitive options might be mandated by the specific dictates of a planned merger. Instances of such unremediable harm, KCS contends, should be relatively rare, and in any event should only be allowed if the proven benefits of the merger could not otherwise be achieved.

[5] On this point, it is interesting to note that BNSF has recognized the "broad consensus that any identified reductions in competition that would be produced by a proposed merger must be directly remedied…". BNSF Reply Comments at 6.

Union Pacific Railroad ("UP") takes particular issue with KCS' proposition that viable competitive routings merit preservation in rail mergers. Specifically, UP points to prior instances where the Board has found that a reduction in competition from three to two carriers in a market did not justify remedial conditions and asks that in the future, such situations continue to be dealt with on a case-by-case basis. UP also takes the opportunity to claim that KCS has posited irreconcilable positions, arguing for the preservation of competition while simultaneously arguing to the Board that The Burlington Northern and Santa Fe Railway Company ("BNSF") should not have been given access to certain shippers at Lake Charles, Louisiana.

As to UP's point that three to two reductions in competition do not merit a condition to preserve competition, KCS would note that a significant body of work, some of it presented to the Board in prior merger cases by KCS and others, establishes that competition is harmed in many such circumstances. KCS also notes that the Board's *NPR* requires all merger applicants to list "two to one" <u>and</u> "three to two" points which would result from a merger (*NPR*, proposed 49 C.F.R. § 1180.7(b)(2)) thus signaling that the Board intends to use closer scrutiny on the likely impacts on competition where the number of independent rail carriers is reduced from three to two.

As to UP's comments regarding BNSF's introduction into the Lake Charles rail market, UP apparently misses the irony laced in its argument. To demonstrate how competition can actually be enhanced through the <u>reduction</u> in the number of independent competitors, UP cites to the Board's approval of its merger with Southern Pacific Railroad ("SP"). However, in that same case, the Board, at UP's request, actually <u>increased</u> the number of independent competitors in a market by granting BNSF access to Lake Charles, Louisiana; a condition that UP advocated as necessary to alleviate the affects of its merger with SP. Which UP position is correct? Is it increasing the number of rail-to-rail competitors that is necessary to alleviate the effects of a rail merger or is it reducing the number of competitors?

KCS has been entirely consistent in the positions that it has espoused before this agency, especially with respect to Lake Charles. KCS has always taken the position that horizontal competition should be preserved in a merger wherever practicable, whether or not that horizontal market had three carriers or five. KCS' position in Lake Charles is entirely consistent with that notion. KCS took the position during the UP-SP merger that certain Lakes Charles' shippers would see their independent routings reduced from two to one absent a condition and advocated a condition that would have preserved two routings in a post-merger environment. KCS opposed BNSF being granted direct access to all Lake Charles shippers, rather than only those who suffered two to one effects, because to do so would give those Lake Charles shippers more competitive options than existed in the pre-merger environment. KCS simply argued that the level of pre-merger competition should be preserved: nothing more, nothing less.

Despite KCS' objections and well established precedents, the Board granted all Lake Charles-area shippers direct BNSF access. Indeed, as a result of UP's actions in the UP/SP merger, the related "CMA Settlement," and the Board's expansion of the terms of that Settlement, certain shippers at Lake Charles went from two carrier access (KCS and SP) prior to the merger to three carrier access (KCS, UP and BNSF) post-merger. It was the Board, with UP's support, that decided to enhance competition by adding three routings to the Lake Charles market instead of the two options that would have existed both pre- and post-merger. Thus, removing BNSF's direct access to the Lake Charles market would do nothing more than restore Lake Charles shippers to their pre-merger status. KCS is thus consistent in its positions:

competition should not be reduced in a merger, nor should it be enhanced beyond what is necessary to remedy a specific harm in a specific market.

In summary, the preservation of all existing rail options, no matter their number, should be a necessary predicate to the Board's intention to explore the enhancement of competition. The Board should firmly establish this principle in its final major merger rules.

II. Service Restrictions Contained In Marketing, Haulage And Trackage Rights Agreements Imposed As Merger Conditions Should Be Disclosed And Justified

Throughout this proceeding, KCS has brought to the Board's attention the problem of restrictions limiting the competitiveness of conditions imposed in prior mergers. The Board and its predecessor have traditionally placed conditions on mergers in an attempt to preserve the competitive options that existed for shippers in certain markets and corridors pre-merger. Often, these conditions were framed quite narrowly, so as to avoid any possibility of making any shipper better off than it was before the merger. Frequently, the conditions contained significant restrictions limiting the scope of the railroad's ability to provide a "fix" for the competitive harm. The downside of placing restrictions on conditions, of course, is that they limit the party exercising the conditional rights from providing the complete array of competitive services that it might provide in the absence of the restrictions. In short, restrictions on conditions suppress the rail network's competitive potential.

As the Board has indicated in the *NPR*, the merger review process is an appropriate venue for the Board to review the possibility for enhancing competition. One limited method of enhancing competition in future merger proceedings would be to reconsider, each time a new merger is proposed, the appropriateness of relevant past restrictions placed on merger conditions involving any of the merger applicants. By making the review of the scope of past conditions a mandatory element of each merger, the Board could gradually implement its revised vision of the public interest. Rail carriers would have to consider the potential impact of increased competition at some of their on-line facilities as one element of weighing the value of their proposed combination. The increased market power sought in some rail mergers would be potentially diminished.

Interestingly, both Norfolk Southern Corp. ("NS") and UP have agreed with KCS that, when reviewing future merger applications, the Board should be cognizant of prior merger conditions and the impact that the current merger will have on those conditions. NS Reply Comments at 45; UP Reply Comments at 6. Specifically, both railroads agree that any prior condition that would be undermined by a future merger needs to be replaced by a condition in the future merger, a position with which KCS agrees. Unfortunately, both NS and UP stop short of advocating a review of the limitations on prior conditions in light of the Board's revised definition of the public interest, and thus both railroads fail to support the more broadly-based enhancement of competitive alternatives favored by KCS. If the Board is truly committed to determining how competitive rail options can be preserved within the existing regulatory framework, it should reassess whether the public interest is served by preventing railroads from realizing their full competitive potential through outmoded restrictions placed on remediative conditions in previous merger cases. At a minimum, the review of the competitive effect of prior conditions provides the Board with a limited, measured, non-speculative way to enhance competition in the rail industry.

KCS' proposal has also been criticized by both NS and UP as requiring the Board to retroactively alter prior mergers. Id. KCS has urged nothing of the kind. The Board is not required to reopen prior merger decisions in order to impose conditions in a current merger that expand the rights granted in a prior merger. For example, if a railroad was granted overhead trackage rights in a prior merger in order to replicate competition between two markets, the Board could condition any future merger on the grant of local rights to that same railroad. No change in the prior merger decision is required. New, expanded operating rights would be granted in addition to those previously imposed.

Moreover, while both UP and NS claim that a future modification of a merger condition would contravene, as UP puts it, "the principle against retroactivity," the Board clearly has the power to amend conditions imposed in prior mergers. To accept UP's and NS' contention on this point would be to hold that all prior merger conditions and decisions are sacrosanct, not to be adjusted no matter how poorly they actually function, no matter how much changes in the rail industry render them anachronisms, no matter how much the Board's perception of the contours of the public interest changes. Such is not the law. Indeed, that is precisely what the Board did with respect to the so-called DT&I conditions. *Detroit, Toledo & Ironton R.R. et al. Control*, 275 I.C.C. 455 (1950) ("*DT&I*"). DT&I-type conditions, which were imposed to protect the traffic flows of various non-merging railroads, were routinely imposed in merger proceedings prior to 1980. After notice and comment, the Board determined that these conditions actually hampered competition and efficiency. As a result, it reopened all prior merger proceedings for the purpose of removing such DT&I conditions. *Rulemaking Concerning Traffic Protective Conditions in Railroad Consolidation Proceedings*, 366 I.C.C. 112 (1982).[6] Few major railroads at that time complained of "improper retroactive rulemaking."

[6] Although the Interstate Commerce Commission's decision in *Traffic Protection Conditions* was later overturned on appeal (*Detroit, Toledo & Ironton R.R. Co. v. ICC*, 725 F.2d 47 (6th Cir. 1984)) because a case-by-case assessment, and not a blanket removal, of all past traffic protective conditions was required, the concept that DT&I Conditions conflicted with the evolved standard of the public interest was not overturned and previous mergers were reopened for the purpose of

In addition, the Board has ample authority under 49 U.S.C. § 11327 to "make appropriate orders supplemental to an order made in a [merger proceeding]" "when cause exists." One recognized condition for exercise of the power to supplement provided in Section 11327 is when "compliance with the condition is no longer in the public interest." *Norfolk & W. Ry. Co., and N.Y., C. & St. L. R. Co. -- Merger*, Finance Docket No. 21510, Slip Op. (ICC decided September 26, 1980). To the extent that the Board deems it necessary to supplement a prior merger decision to bring a condition into compliance with the current notion of the public interest, Section 11327 provides more than ample authority.[7]

The Board's efforts to enhance the competitive vigor of the rail network would be buttressed with a reconsideration of the limitations imposed in prior merger conditions. Reconsideration is not impermissibly retroactive, but is instead entirely consistent with the Board's mandate to adjust past terms and conditions "when cause exits."

III. Benefits Claimed From Prior Mergers Should Be Preserved

The third element of KCS' proposals for improving the Board's major merger rules is the preservation of all benefits claimed to have been generated by prior mergers. The theory behind this proposal is straight-forward. In recent decades, the Board and its predecessor have approved a host of major rail mergers. In each case, the merging railroads secured approval for their

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removing such conditions. KCS' proposal allows the Board to evaluate each past condition in the context of a newly proposed merger; no "blanket" removal of prior restrictions is urged nor is there a need to go back and reopen each prior merger proceeding.

[7] In this same vein, the Board's on-going jurisdiction to modify the conditions imposed in a prior merger is not dependent upon the imposition or pendency of an "oversight proceeding." Oversight provides a helpful, and in some cases necessary, framework for the scheduled review of merger impacts. In light of Section 11327, it is clear that the establishment of the Board's jurisdiction over past mergers does not require imposition of an oversight term, nor does jurisdiction expire with the termination of a discretionary oversight condition.

proposed transaction based upon a series of promised and projected benefits from the merger. In addition, in many instances side agreements were entered into with third parties to secure their support for the planned consolidation. Such agreements often generated both private and public benefits. Many of these agreements were submitted to the agency for authorization. Other agreements were not submitted for approval, but were nonetheless brought to the Board's attention in order to provide a complete understanding of the changes that would result from the merger.

KCS believes that the Board must give recognition to the importance of preserving the benefits generated by past mergers, including those benefits resulting from agreements made with third parties to secure added benefits. Implementation of this proposal would require each future merger applicant to discuss whether or not benefits cited by that applicant in prior mergers would be impacted by the new merger. Applicants would also be required to suggest conditions designed to preserve the benefits allegedly conveyed in the previous merger. Otherwise, public benefits significant to the approval of a prior merger can simply be discounted or erased when a merger applicant chooses a new partner. Theoretically, the very benefits but for which the prior merger may not have been approved may far outweigh the benefits of a subsequent merger but may be lost as a result. Such a possibility at least warrants a rule that requires such a result to be assessed.

The concept embodied in this theory is similar to the request of many parties that the Board use its oversight authority to assure that parties actually work toward realizing the benefits anticipated from their consolidation. See, e.g., New York City Reply Comments at 3. These parties have agreed with the spirit of KCS' proposal, that parties should not simply be allowed to extol the virtues of their consolidation, only to abandon the pursuit of those virtues once regulatory authority is secured. KCS takes this principle one step further, making future mergers dependent upon preserving the benefits generated by prior mergers.

KCS' proposal to put at issue the preservation of prior merger benefits in each merger proceeding is a fitting corollary for the Board's proposed elimination of the "one case at a time" rule. That rule, currently codified at 49 C.F.R. § 1180.1(g), generally states that the Board will not concern itself with the potential impact of any rail merger outside of the merger then under its consideration. In place of this rule, the Board has proposed to require all merger applicants to consider potential downstream merger applications, and to propose conditions consistent with those potential mergers. Unfortunately, while most parties have expressed support for some recognition of matters "outside the record," the proposed new rule has come under justifiable criticism for calling for unsupported speculation. The primary value of the Board's proposed new rule (the consideration of events outside of the instant merger application) is reflected in KCS' proposal to preserve the benefits of past mergers. Moreover, a review of prior benefits is not subject to the same criticism of allowing for too much speculation, because all claimed benefits from past mergers are established and documented as part of the record from previous mergers.

A review of the reply comments filed in this proceeding indicates that few parties have disagreed with KCS's point that merger benefits must be protected in future mergers. However, BNSF has filed comments that might be interpreted as contrary to this view. The specific issue BNSF raises is whether "a merged railroad should be subject to the imposition of new retroactive conditions in response to a subsequent merger or the emergence of unforeseen circumstances." BNSF Reply Comments at 35. KCS agrees with the first two observations that BNSF makes on this position: that subsequent competitive harms presented by a future merger should normally be dealt with during the review of the future merger, and that in any event the "Board already has the ability to take further action if a competitive condition imposed on a merger fails to achieve its results." *Id.* However, BNSF goes on to add its concern that future changes might "remove any finality to Board action and create the risk that the Board would impose far-reaching conditions that the merger applicants would not have accepted as the price of consummating their merger." *Id.* Because KCS' proposal to preserve prior merger benefits should not impose any "far-reaching conditions" on merger applicants, but would merely maintain benefits those applicants touted in prior mergers, KCS does not believe that BNSF's concern should be interpreted as a critique of KCS' proposal.

No party to this proceeding disputes that merging railroads should be required to prove through convincing evidence that the benefits to be secured by a merger will arise and they intend to work toward the realization of those benefits. However, such future mergers should not sidetrack merged railroads from continuing to work toward the realization of benefits arising from prior mergers. The KCS proposal will ensure that benefits promised in prior mergers will not be lost.

IV. Applicants Should Be Required To Disclose And Discuss The Impact Of Related Negotiated Agreements In Merger Proceedings

Despite the fact that the Board's existing major merger rules require the production of a very significant volume of relevant information, the current rules do not require merger applicants to submit to the Board copies of negotiated agreements or settlement agreements reached during the course of, or in contemplation of, a proposed merger. Even though settlement agreements have the potential to affect traffic flows, gateways and other issues that are analyzed in the merger proceeding, applicants are not required to provide the Board or the public with copies of such agreements or to present any analysis or public interest justifications for these agreements. The fact that these agreements are not required to be filed with the Board prevents the Board and the public from making a fully informed decision on the impact of the proposed merger transaction, because a complete record may not have been assembled. The Board has recognized the problems such situations can generate. "When representations are not made on the record, there is no opportunity for us, with the assistance of the parties, to iron out any ambiguities they may involve before we reach a final decision on what conditions to impose." *CSX Corp. and Norfolk Southern Corp. et al. -- Control and Operating Leases/Agreements -- Conrail Inc. et al.*, Finance Docket No 33388, Decision No. 124, Slip Op. at 10 (STB served May 20, 1999).

KCS' proposed rule would establish a procedural method under which applicants would be required to submit copies of all settlement agreements for the record, subject to standard protective order conditions in Board proceedings. Parties would then have 30 days for discovery and to file evidence and comments responding to the settlements. The rule does not require the Board to approve or disapprove the settlement agreements.[8] Rather, the rule allows the Board to take those agreements into account in its deliberations and gives the Board the full picture with which to decide and protect the public interest in the transaction. Full disclosure would also shed light on the motivation of various parties to support or oppose a merger.

KCS does not believe that its proposal to disclose and discuss the impact of merger-related agreements should be at all provocative. After all, parties are not forced to seek approval for their settlement agreements; they are merely required to make the contents of those

[8] Some provisions occasionally found in settlement agreements, such as marketing alliances, are not subject to Board jurisdiction.

agreements part of the record, and to discuss the impact that the agreement will have on the merger and the public interest, if any. Limited disclosure of settlement agreements will not add significantly to the burden of production faced by merger applicants. While it is possible that parties may face a small delay in the approval of their transaction (to allow parties the full 30 days to comment on the agreement and its impacts), whatever inconvenience is generated by the delay will be more than justified by the improvements realized from a more complete factual record.

Despite the obvious benefits of requiring the disclosure of settlement agreements in merger proceedings, one major railroad, CSX Transportation ("CSX"), objected to KCS' proposal. According to CSX, the disclosure of settlement agreements, even under the Board's accepted confidentiality provisions, "could hamper negotiated commercial solutions that are apt to be wiser than nonconsensual regulatory conditions." CSX Reply Comments at 83, n39. Apparently, CSX believes that the merger review process is improved if side agreements (even those having significant impacts on operations, environmental impacts, or labor usage) are left shrouded in speculation and conjecture, and are not accounted for in the Board's final merger analysis.[9] KCS respectfully disagrees. While it is unclear what information CSX anticipates having to shield from the Board's purview, it seemingly is beyond debate that the Board should be informed of any agreement entered into in contemplation of a merger.

KCS notes that although it disagrees with UP on a host of issues in this proceeding, the two carriers do agree that the Board should "require disclosure of any agreement that might bias the views of commenting parties or affect the way the merger will be implemented." UP Reply

[9] CSX has apparently dropped the suggestion it made in its Reply Comments on the *ANPR* that merging parties be required to disclose both the existence of settlement agreements and the parties to those agreements. CSX Reply Comments to *ANPR* at 81.

Comments at 10. Because CSX has not posited any satisfactory explanation as to why the Board would be better served not knowing of the provisions of side agreements, the Board should require that all such agreements be filed with the Board, and that all interested parties be given 30 days to comment on the impact of the agreement. More information is one key to improving both the relevance of STB merger decisions and public confidence in the Board's regulatory prudence.

V. Recent Cancellations Of Reciprocal Switching Access Should Be Disclosed And Discussed

KCS supports a change in the Board's merger rules that would require merger applicants to disclose all facilities, stations, or terminals that had been closed to reciprocal switching[10] within twenty-four months prior to the filing of a notice of intent to merge. Given the lengthy lead time and planning that must be undertaken before a major rail merger is filed, it is highly likely that any cancellation of reciprocal switching imposed during the two years before the filing of a merger application was done in anticipation of the merger. Therefore, the Board should impose a rebuttable presumption favoring resumption of the recently canceled reciprocal switching rights upon the request of any party during the merger proceeding. KCS' proposed rule on reciprocal switching provides the careful balance of preserving competition for those shippers that recently lost access to another carrier because they were closed to reciprocal switching

[10] Reciprocal switching means that a shipper, which may be physically served by only one carrier, nonetheless has access to more than one carrier because the serving carrier has reached an arrangement whereby it will provide, for a fixed fee, a "switch" to another carrier that is located within that terminal, station, or area. In this way, exclusively served shippers (shippers having only one railroad serving their facility) can get competition and access to another carrier. Such shippers are considered "open" to reciprocal switching. Carriers can take away competition by "closing" that shipper to reciprocal switching without seeking Board authority.

without over-reaching and mandating forced competition for those shippers that have never been open to reciprocal switching.

Under KCS' proposed rule, all shippers that request the reinstatement of their reciprocal switching rights that had been canceled by one of the merger applicants within twenty-four months of the filing of a notice of intent to merge would be granted such relief, unless the merging railroads could carry the burden of establishing that the public interest favors the continued restriction of that shipper from reciprocal switching access to another carrier. Reinstating reciprocal switching access is the least intrusive method to protect and maintain recently lost competition. Moreover, little concern should be expressed over whether the provision of reciprocal switching service is operationally feasible. Such service was provided in the recent past, and to the extent that the service was terminated because of operating problems or the like, the merger applicants would be afforded an opportunity to establish their legitimate motivations. Finally, the proposal is not subject to criticism that it improperly enhances competition. In fact, the proposal does nothing more than restore competition that would have existed but for the planned combination.

To the best of KCS' understanding, no party has sponsored any reply comments in this docket that are critical of KCS' suggestion that the Board reverse decisions to cancel reciprocal switching access when done in contemplation of a merger. The absence of opposition to this proposal provides a strong message that it is in the public interest to preserve competitive switching options.

The restoration of reciprocal switching that was canceled within twenty-four months of a notice of intent to merge (unless the merging carriers establish that such restoration would not be in the public interest) provides the necessary balance missing from the extreme and drastic measures of forced reciprocal switching in all terminal areas. Of equal importance is the balance it provides to the insistence of some large railroads on maintaining the status quo. Because this proposal provides a measured, reasoned method of establishing the enhancement of competition in rail mergers, it should be adopted by the Board in its new merger rules.

VI. The Definition Of "Major" Merger Transactions Should Be Limited To Mergers Involving Only The Largest Railroads

The sixth proposal put forth by KCS for modifying the Board's merger rules involves assuring that "major" merger rules are applied only to transactions that merit the Board's most searching level of inquiry. The Board's current rules categorize merger transactions based upon the annual revenues of the merging entities, applying a higher standard of review, and imposing more exacting informational requirements, on transactions involving larger carriers. KCS believes that it is time to modify the standards, based upon the wide disparity between the largest and smallest Class I railroads, to assist in preserving the competitive options provided by the nation's regional freight railroads. Specifically, KCS proposes that mergers involving two or more Class I carriers be treated as "significant" and not "major" transactions to the extent that one of the Class I carriers has net annual operating revenues of less than $1 billion in the previous calendar year, unless the merger is being effected against the corporate will of the smaller Class I carrier, in which case the merger would be treated as a "major" transaction. Such a modification to the existing classifications would more appropriately reflect the current gap among Class I carriers, would better protect the public interest, and would further the Board's directive to minimize regulation of the rail industry.

Pursuant to 49 C.F.R. § 1202.1-1, the Board groups rail carriers into one of three classifications, depending upon annual operating revenues, as follows:

Class I	Over $250 million
Class II	Between $20 million and $250 million
Class III	Less than $20 million[11]

Currently, seven railroads qualify as Class I carriers. Their annual revenues are as follows:

Union Pacific Railroad	$ 10.2 billion
The Burlington Northern and Santa Fe Railway	$ 9.1 billion
CSX Transportation, Inc.	$ 5.6 billion
Norfolk Southern Corporation	$ 5.2 billion
Canadian National Railway (including Illinois Central)	$ 3.5 billion
Canadian Pacific Railway	$ 2.4 billion
The Kansas City Southern Railway Company	$ .5 billion

The disparity between the largest and smallest Class I carriers can also be measured by total track miles:

Union Pacific Railroad	33,705
The Burlington Northern and Santa Fe Railway	33,500
CSX Transportation, Inc.	23,400
Norfolk Southern Corporation	21,800
Canadian National Railway (including Illinois Central)	15,777
Canadian Pacific Railway	14,358
The Kansas City Southern Railway Company	3,718

As easily can be seen from the above listings, and as is readily apparent to anyone familiar with North American railroading, the "Big Seven" is really the "Big Six Plus One." The six largest Class I railroads have much more in common with one another than they do with KCS. Each of the largest Class I carriers boasts annual operating revenues exceeding $2.4 billion dollars. By contrast, KCS' annual operating revenue is less than one-quarter of the smallest of the "Big Six," and its 3,700 track miles is slightly larger than one-quarter of the next Class I

[11] The actual operating revenues used for purposes of classifying railroads are adjusted yearly to take account for inflation. Also, railroads are not reclassified unless they earn three consecutive years of operating revenue above or below their current classification. 49 C.F.R. § 1201.1-1(b)(1).

carrier's mileage. This enormous disparity, which has developed over the last few decades primarily as a result of the numerous large mergers that have taken place, is indicative of the differences between KCS and the other Class I railroads. Obviously, the gap would be even larger between the largest Class I carriers and regional carriers like Wisconsin Central Ltd. ("WC"), Florida East Coast Railway Company, and Montana Rail Link, all of which might soon qualify as Class I carriers.

Based upon these and other disparities, the merger of a Class I railroad with less than $1 billion in annual revenues with a larger Class I railroad does not raise the competitive concerns that would be inherent in the combination of two of the nation's largest carriers. The merger of a consenting small Class I railroad with one of the larger Class I carriers simply does not have the competitive impact found in the merger of the nation's largest railroads, and thus does not justify treatment as a "major" transaction. However, one caveat is necessary to assure that the public interest is fully protected: If the smaller Class I carrier is being merged against its corporate will, it is important that it retain the right to have the proposed merger reviewed under the heightened "major" merger standards. Given the significant operational problems that have developed during recent voluntary mergers, close attention must be paid to every aspect of the transaction if one party to the transaction may not believe it to be in its best interests.

The Board's recent proposal to require consolidated financial reporting by commonly controlled railroads (*Consolidated Railroad Reporting*, Ex Parte 634 (STB served September 25, 2000) ("*Reporting*")) strongly supports the exclusion of smaller Class I carriers from the "major" merger category. In *Reporting*, the Board indicated that it might adopt Financial Accounting Standards Board Statement No. 94, *Consolidation of All Majority-owned Subsidiaries* (1987) ("FASB 94"), which would require that railroads consolidate the reporting of financial information for all majority-owned and controlled subsidiaries. Adoption of FASB 94 by the Board would hasten the process by which larger Class II carriers move into the Class I ranks, and would greatly increase the number of potential "major" mergers under the Board's merger rules without any corresponding need to subject such smaller Class I carriers to a "major transaction" status. The potential adoption of FASB 94 by the Board provides yet another reason for the Board to reduce the merger of consenting small and large Class I carriers to "significant" status.

Several parties have expressed concern over KCS' proposal for the treatment of smaller Class I carriers in merger proceedings, but these criticisms are without basis. The Committee to Improve American Coal Transportation ("IMPACT"), while conceding that "[t]here is merit in this proposal," is concerned that acquisition of a smaller Class I railroad "could have a crucial effect on the overall structure of the railroad industry." IMPACT Reply Comments at 42. Nonetheless, IMPACT concludes that if the Board adopts pro-competitive merger rules, as it has proposed to do, it "may be possible" to review the merger of a smaller and a larger Class I carrier under the Board's "significant" standards. *Id.*

UP also finds fault with KCS' proposal. While conceding that in certain unspecified instances the merger of a smaller and larger Class I railroad might "not have national significance," UP expresses concern that KCS (or, more particularly, KCS' management) could use the possibility of invoking the "major" merger rules as a shield to protect "incumbent management by making the acquirer's task more difficult." UP Reply Comments at 37. UP's error is made evident in its statement that "[t]he public has no interest in protecting incumbent KCS managers from an acquisition by another railroad." *Id.* As KCS has detailed above, and has shown in other filings in this proceeding, the public interest is clearly jeopardized if a railroad is going to be taken over against its corporate will. Rather than serving as a protection of management, or as an obstacle for an unwanted suitor to overcome, application of the "major" merger standards is mandated by the adverse nature of the proceeding and the need to ensure that the benefits of any such proposed transaction can nonetheless be achieved in light of the hostile nature of the transaction.

Finally, KCS notes that both the United States Department of Transportation (USDOT Reply Comments at 7) and Wisconsin Central (WC Reply Comments at 3) continue to support the concept that a reduced standard of review may be invoked for mergers involving smaller Class I carriers. Given the disparity in market reach between the largest and smallest Class I carriers, this support is well grounded in both fact and theory. Therefore, the Board should amend its merger rules to provide that, under the circumstances described herein, smaller Class I carriers may be merged into larger Class I carriers under the Board's "significant" transaction rules.

VII. Merger Applicants Should Be Required To Disclose And Discuss Paper And Steel Barriers Applicable To Their Shortline Interchange Connections.

One of the most vexing problems facing shortline and regional railroads in the last few decades has been the existence of paper and steel barriers. "Paper barriers" are contractual restrictions that prevent a shortline from interchanging traffic with any rail carrier other than the carrier from which the shortline bought its rail property. "Steel barriers" are sections of track, principally at one or both ends of a rail line, that are retained by a railroad when it sells a rail line, to isolate the line from other competing carriers. The effect of both paper and steel barriers is the same: to render the newly-created shortline captive to its Class I connection. Captivity of the shortline limits shippers' alternatives and limits the revenue obtainable by smaller railroads. In light of the well documented need of smaller carriers to generate sufficient capital to maintain and improve track, elimination of restrictions on their competitive options should be implemented.

KCS' proposed rule would require merging major carriers to disclose the paper and steel barrier impediments that prevent their shortline and regional railroad connections from interchanging and competing, and justify the retention of the barriers in light of changes in competitive circumstances that their merger would create, and in light of the Board's revised vision of the public interest. Such disclosure will more fully inform the Board of its options to preserve or enhance needed competition in a way that does not radically alter the competitive landscape. As one of the chief concerns regarding the Board's intention to enhance competition has been the open-ended nature of that directive, KCS' proposal to review paper and steel barriers provides a measured, limited method for implementing competitive enhancements in a directed, focused manner.

A number of parties have addressed the paper and steel barrier issue in their reply comments. As expected, the comments run the spectrum from parties seeking the removal of all such barriers, even outside a merger context, to those invoking the sanctity of contractual rights and urging the Board to ignore these impediments to enhanced competition. A review of the merits of these diverse proposals indicates that a compromise position, as suggested by KCS, is the most balanced, reasoned resolution to the debate. Those seeking the lifting of all barriers to competition would be heartened by the removal of barriers that cannot be justified on a public interest basis. Those focused on holding parties to their contractual bonds would be pleased with the fact that no barriers would be lifted without future merger applicants having an opportunity to justify why such barriers are in the public interest. This balanced approach to the controversial issue of paper and steel barriers is an appropriate (and, to KCS' thinking, necessary) element of any plan to enhance competition through approval of major mergers.

CONCLUSION

As KCS has emphasized throughout this proceeding, it appreciates the opportunity to address the Board on the important subject of future major merger rules. Significant strides toward improving the existing rules are evident in the *NPR.* KCS believes that with only slight adjustment to those proposed changes as put forth herein, the Board will establish a middle ground of rigorous, balanced measures to effectively regulate mergers in accord with the public interest for many years to come.

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January 11, 2001

CERTIFICATE OF SERVICE

This is to certify that on this 11th day of January, 2001, I caused the foregoing "Rebuttal Comments of the Kansas City Southern Railway Company on the Notice of Proposed Rulemaking" in the Ex Parte No. 582 (Sub-No. 1) proceeding to be served upon counsel for all known parties of record by first class mail, postage prepaid, or by more expeditious means.

Tom Healey

Thomas J. Healey